

## **An Account of Reforms in Emerging Markets; Time to Reflect**

Over the past few years emerging market equities and bonds have outperformed developed markets considerably. Net inflows into emerging market equity funds hit a record of US 20.3 billion in 2005 and in January 2006, they reached US 11 billion in just one month. Although long term yields are still below those of developed markets, emerging market shares did deliver 165% total returns between 2003 and 2005. Recently, the average size of initial public offerings in China has overtaken levels in the US and Europe the first time in history.

One reason explaining the popularity of emerging markets is growing global liquidity; a second reason is the ongoing restructuring and transformation of emerging market economies. Fiscal and political stability achieved as a result of reforms has lowered systemic risks, current account deficits are being eliminated, average inflation is down to 1%, reserves are at record highs and risk spreads are at their lowest in history. Lower risks, higher growth rates and geographical diversification of emerging markets keep attracting under-funded pension funds that are looking for extra yields.

In my view this boom in emerging markets is however, pushing corporate governance out of sight and out of mind.

Until recently, corporate governance reforms were high on policy agendas in many developing countries. Reforms were primarily concerned with the design of a legal and regulatory framework to offer better protection to potential investors. Although different paths were followed and, depending upon prevailing conditions, differing priorities assigned, the tools and mechanisms used converged around OECD Guidelines, IFRS, IOSCO and IFAC standards. SOX should also be praised as a source of inspiration in this process despite the calls for “less” or “better” regulation in its home country.

Policy makers initially relied on regulations and codes to bridge the gap between desired laws and existing legal frameworks and focused on listed companies although the bulk of economic activity is generated by non-listed companies in those countries<sup>1</sup>. Regulatory reforms served to increase awareness of the importance of corporate governance, but also raised issues with respect to the alignment of laws and regulations, the consistency of legal frameworks, weaknesses in enforcement and monitoring, and unfair competition by more opaque competitors. In some countries regulatory burden put additional strains on listed companies and slowed the rate of initial public offerings. Developments in Russia, Brazil, India, Turkey, Hong Kong and Korea provide a rich experience base to reflect upon. The debate is now turning to the outcome of reforms.

One of the most important lessons driven from this “governance reform era” in my view is the persistency of ownership structures. Concentrated ownership underpinned by business groups and the pyramidal structures are ubiquitous in emerging markets. The recent debate concerning Mittal’s attempted takeover of Arcelor raised issues

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<sup>1</sup> In 2005, this issue was raised and debated in an international conference held in Istanbul and organised by the OECD.

regarding complex and cascaded ownership structures on a global scale – whereby a publicly listed parent company can be an empty shell with “model” corporate governance practices, while holding controlling shares in unlisted and opaque subsidiaries in countries with lower corporate governance standards.

The traditional view is that concentrated ownership is a response to weak shareholder protection. Some studies also suggest that business groups may compensate for missing institutions and offer greater resilience to crises than individual companies. Recently, it has further been argued that pyramidal structures, contrary to the common view, may not be driven by the desire to divert private benefits but to provide an effective means of financing new ventures with the retained earnings of existing businesses where access to external capital is expensive and/or limited.

Regardless of their motives, it is unavoidable that controlling shareholders will expect some level of private benefit to compensate their monitoring costs and reduced liquidity. I argue that although concentration of ownership may be a potent mechanism where courts and other institutions are weak, it may also be an obstacle to reforms. Firstly, as mentioned before, we do not observe changes in ownership and control patterns following improvements to corporate governance frameworks in emerging markets. Secondly, in most cases, controlling shareholders use their economic and political power to lobby against reforms or their effective enforcement. Concentration of ownership, in the absence of democratic traditions and good law, weakens the effectiveness of governance provisions; at excessively high levels of concentration, minority shareholders have little incentive to monitor even if laws protect their rights. In many emerging markets, especially where pension funds are just emerging, shareholder activism and private enforcement are also very rare.<sup>2</sup>

One of the widely used control mechanism in emerging markets is Shareholders' Agreements between large shareholders who can jointly have full decision making power. Corporate governance standards adopted by emerging markets mimicking the governance provisions of developed market economies usually ignore the disclosure of such agreements<sup>3</sup>. Opacity of ownership structures add to the problem. In most cases major stakes are held via offshore private companies, making it difficult to identify related parties.

Concentration of ownership changes the nature of the agency problem. Conflicts of interest between management and shareholders are largely eliminated - since in most cases, controlling shareholders either participate in company management or have strong incentives to monitor the management closely. Even if fraud and diversion are controlled however, there are several reasons why this is inadequate: Monitoring by controlling shareholders relies heavily upon the managerial skills of a much narrower gene pool. The absence of specialised intermediaries such as credit-rating agencies, investment analysts and independent researchers, adds to monitoring deficiencies in emerging markets. Most emerging markets have furthermore, a serious shortage of certified auditors with sufficient experience and competence, especially in the application of complex IFRS. They frequently fail to detect material misstatements. Related party transactions remain undetected and unreported due to the complexity of

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<sup>2</sup> On the other hand, excessive use of minority shareholder rights can also pose a potential risk of abuse. Examples are abundant - especially in Eastern European countries.

<sup>3</sup> Exceptions exist such as in Mexico.

ownership structures. The merits of concentrated ownership are therefore dubious as an alternative corporate governance mechanism in emerging markets.

While the pyramidal structures or business groups may offer efficiencies to controlling shareholders and possibly to external investors in individual companies, this is not enough to establish efficiency from the perspective of social welfare. The persistency of concentrated ownership and group structures may impede the development of external capital markets and economic development. More importantly, concentration of economic power slows down the process of democratisation in most emerging countries where the societal culture is characterised by power distance. Underpinned by extensive rules and regulations but weak institutions; these markets are prone to opacity and corruption. Recent scandals at Yukos (Russia), China Aviation Oil (Hong Kong), Hyundai, Samsung, SK Corp and KT&G (Korea), Russia's ban on Hermitage's manager from entering the country and corruption allegations at Taiwan's financial authority also highlighted the interplay between governments and powerful owner/managers. Selective use of regulatory power and abuse of golden shares continue to undermine the essence of reforms.

Partly attributable to the persistency of ownership and control structures, recent empirical research into emerging markets demonstrates that the relationship between traditional corporate governance mechanisms and accounting performance is, at best, weak.<sup>4</sup> In my view, the persistence of control structures in emerging markets can be explained by their defining characteristic: the political structure<sup>5</sup>. Regulators face difficulties in tackling insider dealing - the most important method of value transfer, and poor disclosure where the financial community is tightly-knit and where there are extensive links between large companies and the ruling elite. Non-pecuniary private benefits such as economic power, recognition and prestige can further lead to more financial and political power for controlling shareholders.

There is a growing consensus amongst economists that the best development strategy for an emerging market country is to constitute the conditions that produce a sound equity market - for which strong corporate governance institutions are a pre-condition. Experience teaches us however that unless ownership and control structures are transformed, and concentration is reduced to a moderate level, better laws and regulations may not be sufficient alone to generate a deep and liquid market. Moreover, it is questionable whether it is possible to have a properly functioning stock market in the absence of a free press, a vibrant civil society and well functioning democratic institutions; these can only emerge with the dispersion of economic and political power. Dispersion of ownership may be the starting point.

We may need to wait until prices go down in emerging markets before investors focus on CG issues again. More investors are embracing a passive, index-based investment strategy - based on liquidity and market cap indicators - favouring the large groups that dominate the local economy. This further undermines the importance of corporate governance; corporate governance, however remains a vital imperative for the sustainability of emerging market economies. Recent warnings by a UK based asset

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<sup>4</sup> Market performance does improve with adoption of "best practices", possibly due to increased investor confidence.

<sup>5</sup> The groups and pyramids are not a concern only for emerging markets; EU has also been struggling to reach a consensus on a legal framework for groups and pyramids since 1984 without much success.

management company about the upsurge of flotation of Russian companies in LSE on the basis of opacity and difficulties of dealing with the Russian legal regime is an indication of growing concerns on the investors' ignorance of corporate governance matters. Investing in emerging markets is a complex issue and international institutional investors have an even more important role to play...

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